No. 88-940

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# In the Supreme Court of the United States

OCTOBER TERM, 1988

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BANK ONE, STEVENS POINT, NA, PETITIONER

*v.*

UNITED STATES DEPARTMENT OF COMMERCE, ET AL.

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

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## BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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## QUESTION PRESENTED

Whether the government is required to honor loan guarantees made pursuant to provisions of the Trade Act of 1974, 19 U.S.C. 2341 *et seq.*, when the lending bank materially breached the terms of the loan guaranty agreements and the government neither directed nor encouraged those breaches.

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is reported at 854 F.2d 223. The opinions of the district court (Pet. App. A13-A20, A61-A69) are not reported.

### JURISDICTION

The judgment of the court of appeals was entered on August 8, 1988. A petition for rehearing with suggestion for rehearing *en banc* was denied on September 9, 1988. Pet. App. A75. The petition for a writ of certiorari was filed on December 7, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### STATEMENT

1. Petitioner, a bank in Stevens Point, Wisconsin, had for several years made loans to Weber Plastics and Weber

Tackle, Inc. (Weber or Weber Companies) that Weber did not repay. Pet. App. A1, A13. In 1979, Weber approached petitioner for new loans to finance its fishing tackle operations and plastics manufacturing facility and to purchase new and modernize existing equipment. Pet. App. A14. Because of Weber's unsatisfactory credit history and large debt, petitioner and other local banks refused to make the requested loans. *Ibid.*

In October 1980, Weber sought financial assistance in the form of a loan guaranty from the United States Department of Commerce's Economic Development Administration (EDA) pursuant to provisions of the Trade Act of 1974, 19 U.S.C. 2341 *et seq.* Pet. App. A2, A14. The Trade Act authorized the EDA to provide financial assistance to American firms hurt by imports which had "no reasonable access to financing through the private capital market," but provided a "reasonable assurance of repayment of the loan." 19 U.S.C. 2342(b)(1)(A), 2345(a)(2)[1]; see Pet. App. A2. A necessary step in the loan guaranty application process was the preparation of a "Diagnostic Analysis and Recovery Plan." Pet. App. A14. Weber presented an initial draft of the plan to the EDA and to petitioner for review. After revisions (based upon petitioner's comments) were made in the recovery plan, it was approved by EDA. Petitioner thereafter agreed to loan Weber a total of $2.1 million, 90% of which was guaranteed by EDA. Pet. App. A14-A16.

Under the terms of the guaranty agreements, petitioner agreed to certain terms and conditions, including the re-

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[1] The Trade Act was amended in 1986 to provide that "no direct loans or guarantees of loans" could be made under the adjustment assistance provisions after April 7, 1986. 19 U.S.C. 2344(d) (Supp. IV 1986). Section 2342(b) now provides for technical assistance alone. Consolidated Omnibus Budget Reconciliation Act for 1985, Pub. L. No. 99-272, Tit. XIII, § 13006(a)(1) and (b), 100 Stat. 304.

quirement that it would exercise "such care and diligence in the disbursement, servicing, collection and liquidation of the Loan as would be exercised by a reasonable and prudent commercial bank in dealing with a loan of its funds without guaranty * * *." Pet. App. A2. Each guaranty also provided that "if the bank 'failed to comply with all of the material provisions' of the agreement[,] the government could terminate the guaranty." *Ibid.*

On November 13, 1981—after the guaranty agreements were signed, but before the loans were closed—Weber's accountants issued a Financial Report for the Fiscal Year ending July 31, 1981, which showed that Weber's losses for that year were more than double the $250,000 loss projected in the recovery plan. Pet. App. A8, A87, A88. Petitioner received a copy of the report and, on December 7, 1981, forwarded it to the EDA along with other materials. Pet. App. A87.[2]

The Weber loans were closed on December 17, 1981. Pet. App. A15. On that date, the EDA's Regional Director wrote a letter to petitioner in which he opined, on the basis of an affidavit and statements made by Weber's President and Treasurer (Remer Hutchinson), that since the date of the acceptance of the guaranty agreements by the petitioner, there had been "no unremedied adverse changes in the financial condition of Weber Tackle Company sufficiently serious * * * to warrant withholding disbursement on account of the referenced loans." Pet. App. A90.

On October 18, 1982, Weber defaulted on the loans. (It later went out of business). Pet. App. A3, A16. Petitioner timely notified EDA of the default. Pet. App. A16. Later,

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[2] It was undisputed in the court of appeals that the petitioner had received the Financial Report and sent it to the EDA before the loans were closed, although the district court was uncertain about this point. See Pet. App. A17.

on June 15, 1984, petitioner demanded that EDA honor its guarantees and repurchase the EDA-guaranteed portion of the loans. *Ibid.* On February 20, 1986, after the matter had been investigated by the Inspector General of the Department of Commerce, the EDA refused to acknowledge liability on its guaranty agreements. Pet. App. A16, A43.

2. Petitioner originally brought suit against Weber in state court, seeking to foreclose on Weber's assets that had secured the loans. Pet. App. A3. Weber answered the complaint and asserted a third-party complaint against the government. *Ibid.* After the government removed the case to the United States District Court for the Western District of Wisconsin, petitioner twice amended its complaint and ultimately named as defendants, among others, the Secretary of Commerce in his official capacity,[3] Weber, and the individual respondents Remer and Elaine Hutchinson.[4] Pet. App. A3, A4, A13.

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[3] Section 2350 of Title 19 of the United States Code provides that the Secretary of Commerce may sue and be sued in United States District Court regardless of the amount in controversy. Although petitioner named other federal defendants in its suit (the United States Department of Commerce, the United States, and the EDA), it sought no separate relief against them and, as the court of appeals recognized (Pet. App. A5), they should have been dismissed. For the sake of simplicity, we will hereinafter refer to the governmental defendants collectively as the "federal respondent."

[4] Remer Hutchinson, the former president of Weber Companies, owned a controlling interest in the companies. Pet. App. A22. His wife, Elaine Hutchinson, was the former Secretary of the companies. Pet. App. A23. The individual respondents counterclaimed against petitioner, alleging that petitioner had agreed to subordinate its priority position with respect to certain collateral to their personal claim for $150,000 advanced to Weber, and filed a cross-claim against the federal respondent, alleging that it was aware of the subordination agreements, and by guaranteeing the loans, had effectively subordi-

3. The district court conducted a one-day bench trial on the loan guaranty issues. After examining those of petitioner's activities that the federal respondent claimed had breached the guaranty agreements, the court concluded that the federal respondent should not be released from its guaranty obligations. Pet. App. A13-A20.

First, the district court found that Weber's audited Financial Report for the year ended July 31, 1981 should have raised questions about the viability of the recovery plan, that both petitioner and the federal respondent should have obtained the report prior to closing the loans, and, therefore, that each entity should bear responsibility for its imprudent acts. Pet. App. A17.

Similarly, the district court was "distressed" at the petitioner's practice of allowing Weber to acquire additional fixed assets before having them approved, and of disbursing loan proceeds after Weber had defaulted. But it found the government estopped from protesting against these practices since it, too, generally followed "sloppy procedures" in approving fixed asset expenses and had not protested either that practice or the continued disbursement. Pet. App. A17-A18.

Finally, the district court found that petitioner's disbursement of the loan proceeds into a checking account controlled by a Weber company not party to the loans had been imprudent, but had caused no harm. Pet. App. A18. It held that petitioner's practice of allowing Weber to maintain substantial overdrafts and to violate certain

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nated its own interest in the collateral. Pet. App. A61-A69. Ultimately, petitioner and Weber entered into a stipulation for entry of a judgment of foreclosure and replevin against Weber. Pet. 10 n.10. Later, the district granted summary judgment for petitioner against the individual respondents, and summary judgment in favor of petitioner and the federal respondent on the individual respondents' counter- and cross-claims. Pet. 12.

negative covenants in the guaranty agreements was likewise harmless. Pet. App. A19.

4. The court of appeals reversed and directed the district court to dismiss petitioner's claim against the federal respondent on the merits. Pet. App. A11. Observing that "[t]he district judge agreed with the government that the bank had acted imprudently," the appellate court concluded that "the bank's conduct amounted to a material breach * * * which therefore excused the government from performing its obligations under the guaranty" because "the evidence overwhelmingly established that th[e] undemanding standard [for a material breach] was satisfied, and the district court's (unexplained) disagreement with this conclusion we deem clearly erroneous." Pet. App. A9-A10.

The appellate court then turned to the district court's conclusion that "the bank's imprudence was somehow cancelled by the government's." Pet. App. A10. The court of appeals held that "nothing in the guaranty agreement enjoins the guarantor to vigilance." *Ibid.* It also noted that while some subordinate EDA officials had turned a "blind eye" to some of the petitioner's imprudent acts, none of those officials had any actual or apparent authority to modify the terms of the guaranty agreements, *ibid.*, so that "[t]he failure of the Economic Development Administration's regional staff to insist upon compliance with [the provision requiring petitioner to act with the prudence of a normal commercial bank making the loan without a government guaranty] * * * does not open the vaults of the Treasury to a bank that violated the provision." Pet. App. A10-A11. Finally, although recognizing that "[t]he question whether and in what circumstances the federal government can be estopped by an act of its agents remains unsettled," the court of appeals held that petitioner's estoppel argument failed in any case because

petitioner had not demonstrated that even "the traditional elements of an estoppel" were present. Pet. App. A11.

**ARGUMENT**

1. Petitioner's main contention is that the court of appeals erred in failing to hold the government estopped by its own imprudent behavior from asserting petitioner's material breach of the guaranty agreements. Petitioner's objection, however, is not to any error in the legal standard adopted by the court here. While we maintained below and continue to believe that the government is not subject to estoppel in this case (see *Federal Crop Ins. Corp.* v. *Merrill,* 332 U.S. 380 (1947)), the court in fact assumed for the purposes of the decision that the government *was* susceptible to estoppel. Noting that "[t]he question whether and in what circumstances the federal government can be estopped by an act of its agents remains unsettled," the court explicitly followed the approach adopted by this Court in *Heckler* v. *Community Health Services of Crawford County, Inc.,* 467 U.S. 51, 61 (1984), to hold that " 'however heavy the burden might be when an estoppel is asserted against the Government, the private party surely cannot prevail without at least demonstrating that the traditional elements of an estoppel are present.' " Pet. App. A11. Petitioner's objection is thus simply to the application of that standard to the facts of this case, and specifically to the court's conclusion that "there was no reliance by the bank." *Ibid.*; see *Community Health Services,* 467 U.S. at 61, 66 (requiring "reasonable reliance" as element of estoppel).[5]

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[5] Petitioner's repeated attempts to distinguish cases like *Schweiker* v. *Hansen,* 450 U.S. 785 (1981); *Federal Crop Ins. Corp.* v. *Merrill,* 332 U.S. 380 (1947); *Wilber Nat'l Bank* v. *United States,* 294 U.S. 120 (1935); and *Utah Power & Light Co.* v. *United States,* 243 U.S. 389

The court of appeals' holding in this case that there was insufficient evidence to support a finding of reasonable reliance does not warrant this Court's review. Under the plain terms of the guaranty agreements, petitioner had a contractual responsibility "to administer the loan in the same fashion as would a 'reasonable and prudent commercial bank' in dealing with a loan that had not been guaranteed by the United States Government." Pet. App. A7-A8. That is, the bank was not supposed to look to the government to guide its actions. To the contrary, it was obliged by the terms of the guaranty agreements to exercise its judgment independently, guided by the practice of other commercial institutions. Petitioner does not contend that the terms of the contract were modified so as to release petitioner from its obligation to act as a "reasonable and prudent commercial bank."[6] Petitioner cannot demonstrate how it otherwise might reasonably have relied on the

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(1917), in which this Court has held estoppel against the government inappropriate, are beside the point. The court of appeals did not reach the question whether the government could be estopped on the facts of this case because it found that petitioner had failed to satisfy the traditional test for estoppel. For the same reason, petitioner's invocation of *Franchise Tax Bd.* v. *United States Postal Service*, 467 U.S. 512 (1984) and *Loeffler* v. *Frank*, No. 86-1431 (June 13, 1988) is gratuitous. *Franchise Tax Bd.* and *Loeffler* concern the obligations assumed by the Postal Service in its commercial role given a "sue and be sued" clause, and do not concern the circumstances under which such an entity might be estopped. Although petitioner cites those cases to support the proposition that when the government enters into commercial activities, its liabilities are the same as those of other private entities, the court of appeals had already assumed as much in this case when it applied the principles of estoppel to the circumstances presented here.

[6] The court of appeals' determination that the subordinate officials with whom petitioner dealt had no "authority to modify the terms of the guaranty" is germane to no wider point. See Pet. App. A10.

government; the court of appeals did not err in concluding that the district court's unexplained conclusion to the contrary was mistaken.

Petitioner observes (Pet. 20-22), as did the court of appeals (Pet. App. A11), that the law of estoppel remains unsettled. As petitioner notes (Pet. 20-22), a number of courts of appeals have held that the government may not be estopped when it acts in its sovereign capacity (see, *e.g.*, *United States* v. *Florida*, 482 F.2d 205, 210 (5th Cir. 1973); cf. *United States* v. *Mattuci*, 502 F.2d 883 (6th Cir. 1974)); other courts have held that the government may be estopped when it acts in a "proprietary" capacity as when its activities are arguably analogous to those of a private concern (see, *e.g.*, *Federal Deposit Ins. Corp.* v. *Harrison*, 735 F.2d 408, 412 (11th Cir. 1984); *Branch Banking & Trust Co.* v. *United States*, 98 F. Supp. 757 (Ct. Cl.), cert. denied, 342 U.S. 893 (1951)); still others have eschewed the sovereign/proprietary distinction, and have held that the government may be estopped only if, in addition to the traditional elements of estoppel, the government's agents have engaged in "affirmative misconduct" that causes "serious injustice" to the complainant (see, *e.g.*, *Wagner* v. *Director, Federal Emergency Management Agency*, 847 F.2d 515, 519 (9th Cir. 1988); *Morgan* v. *Heckler*, 779 F.2d 544, 545 (9th Cir. 1985)).[7]

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[7] *Maxima Corp.* v. *United States*, 847 F.2d 1549 (Fed. Cir. 1988), and *Brown* v. *Marsh*, 777 F.2d 8 (D.C. Cir. 1985), cited by petitioner (Pet. 20-21), are not relevant because they do not concern estoppel. In *Maxima Corp.*, the court held that under contract law the government could not retroactively apply a "termination for convenience" clause to a contract already fully performed on both sides. In *Brown*, the court held that a plaintiff had substantially satisfied his duty to exhaust administrative remedies, adding that, where the obligation did not have the nature of a jurisdictional bar, the government could not press the obligation as a legal defense when it had failed to raise the defense sufficiently below.

Under any of these approaches, however, the government would not have been estopped here. Petitioner failed to demonstrate even that the traditional elements of estoppel, let alone "affirmative misconduct" causing "serious injustice," existed here. Since the result in this case would not have been different in any circuit, any conflict that exists among the courts of appeals in their treatments of estoppel cases is not presented by the decision in this case.[8]

2. Petitioner also claims that the court of appeals engaged in improper factfinding. See *Icicle Seafoods, Inc.* v. *Worthington*, 475 U.S. 709, 714 (1986). Although the court of appeals arguably engaged in commentary unrelated to the issues developed before the district court and unnecessary to the disposition of the case,[9] there was no disagreement as to the key factual finding. The district court found (Pet. App. A17-A20), and the court of ap-

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[8] In a related vein, petitioner suggests (Pet. 22-23) that it might benefit by an application of "appropriate principles of guaranty law," even if it cannot demonstrate the traditional elements of an estoppel. See Pet. 22 (citing *Lyng* v. *Payne*, 476 U.S. 926, 936 (1986)). Even assuming that such an approach would be proper here, an element of the guaranty agreement at issue in this case was the requirement that the bank exercise its independent "reasonable and prudent commercial" judgment. There was no corresponding requirement placed on the federal respondent to evaluate and verify whether petitioner's actions were those of a "reasonable and prudent commercial bank." See Pet. App. A10. Nor did the government ever take such action. The petitioner failed to meet a material requirement of the guaranty; it therefore cannot seek to enforce the guaranty.

[9] For example, petitioner objects (Pet. 24 n.16) to the court of appeals' characterization of petitioner's decision to close the loans as "yield[ing] to [the] temptation" to take advantage of the government's guaranty program (Pet. App. A8). This statement, however, is simply part of the court's generic observation that a bank could be expected to close a deal if it decided that the deal worked to its commercial self-interest; it is not specifically related to the court's disposition of this case. See *Ibid.*

peals agreed (Pet. App. A10), that petitioner had acted imprudently in closing the Weber loans, and in the way it serviced those loans. This Court does not sit to review that factual finding. *Tiffany Fine Arts, Inc.* v. *United States,* 469 U.S. 310, 317-318 n.5 (1985); *Graver Tank & Mfg.* v. *Linde Air Products Co.,* 336 U.S. 271, 275 (1949).

The main disagreement between the court of appeals and the district court did not concern the finding that the petitioner had acted imprudently, but the legal consequences of that finding. Specifically, unlike the district court, the court of appeals held that the imprudence of the petitioner in closing the loans, like its subsequent imprudence in servicing the loans, violated its contractual obligation to act as a "reasonable and prudent commercial bank." Pet. App. A7-A9. It ruled that the "reasonable and prudent" requirement was a "central undertaking of the promisor." Pet. App. A9. Once that central undertaking was recognized to be at issue, and the court of appeals had determined that the district court's refusal to impute responsibility to the petitioner for the making of the loans was mistaken,[10] the conclusion that the district court had

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[10] The obligation of the bank to act as a "reasonable and prudent commercial bank" appeared in the guaranty agreements. In the court of appeals' view, the provision was susceptible to two interpretations: it could be interpreted as requiring "reasonable and prudent behavior" subsequent to the closing of each loan, or as requiring such behavior from the beginning of the transaction (including the closing of the loan as a necessary component of its later disbursement). Pet. App. A9. The court of appeals correctly noted that the petitioner waived the argument that the "reasonable and prudent" requirement did not apply to it from the beginning of the transaction by failing to make the argument below. *Ibid.* While petitioner suggests (Pet. 20 n.13) that it did raise the issue below, its argument in the cited pages goes only to the contentions that the petitioner did not act imprudently, that the government acted imprudently as well, and that a guarantor is not entitled to expect prudent action from a bank. It does not assert that it

clearly erred when it found (Pet. App. A19) that "[t]here has been no substantial and material breach of duty" by the petitioner was compelling. Pet. App. A9-A10.

3. Petitioner also seeks certiorari with respect to the court of appeals' ruling that the district court had no pendent party jurisdiction over petitioner's state law claim against the individual respondents, the Hutchinsons. The federal respondent is not affected by that ruling.[11] We note, however, that the issue raised by the petitioner does not require this Court to hold the petition pending disposition of *Finley* v. *United States,* cert. granted, No. 87-1973 (Oct. 3, 1988). Petitioner's arguments and those involved in the *Finley* case concerning the propriety of pendent party jurisdiction are based on the premise that the threshold requirements making pendent jurisdiction appropriate have been met. See *United Mine Workers* v. *Gibbs,* 383

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had no obligation to act prudently under the guaranty agreement itself. In any event, the petitioner does not ask this Court to review the court of appeals' interpretation of the particularities of the guaranty agreements employed here, an issue of little continuing importance given the amendment of the Trade Act to exclude financial assistance from the government. See 19 U.S.C. 2342(b), 2344(d) (Supp. IV 1986).

[11] The district court granted summary judgment for the federal respondent on a cross-claim filed against it by the Hutchinsons. The Hutchinsons had claimed that the federal respondent, by virtue of guaranteeing the Weber loans, had acquiesced in certain letter agreements by which the petitioner, and therefore the federal respondent, had subordinated its interest in certain collateral to that of the individual respondents. The court of appeals took no express action on the district court's ruling on this claim, but vacated its judgment disposing of petitioner's claim against the Hutchinsons and directed that it be dismissed for lack of subject matter jurisdiction. The individual respondents have not sought review of the court of appeals' decision. Rather, only the petitioner seeks to have the disposition relevant to its claim reviewed. The pendent party claim therefore does not concern the federal government.

U.S. 715, 725 (1966) (federal claim must be of sufficient substance to support subject matter jurisdiction, federal and state claims must be derived from "common nucleus of operative fact," and be such that plaintiff would ordinarily be expected to try both in one judicial proceeding). Unlike the district court in *Finley,* the court of appeals here rejected that premise. It found that it did not have to consider the propriety of pendent party jurisdiction because the petitioner had not demonstrated that its claim against the federal government and its claim against the individual respondents involved the same "common nucleus of operative facts." Pet. App. A7 (quoting *Gibbs,* 383 U.S. at 725). As the court explained, "[t]he bank's claim against [EDA] * * * concerns the terms of the guaranty agreement and the behavior of both the bank and the EDA in administering the loan. The bank's claim against the Hutchinsons involves the terms of its agreement with the Hutchinsons. There is no overlap of legally pertinent facts or legal principles." Thus, contrary to petitioner's contention that the Seventh Circuit failed to apply the *Gibbs* common nucleus test (Pet. 27), the Seventh Circuit applied the test and determined that "[t]he operative facts * * * are separate nuclei with much space between them." Pet. App. A7. Since the claim here did not meet the threshold requirement for pendent jurisdiction, this case does not raise the question of pendent party jurisdiction.

## CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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